



Stricter enforcement may increase tax evasion

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Abstract

This paper shows that stricter enforcement may increase tax evasion. Individuals vote on a linear income tax, which is used to finance lump sum transfers. Individuals may evade taxes, but they have to pay fines when caught. Stricter enforcement may make redistributive taxation more attractive to the decisive voter. The tax rate and transfer may rise, which in turn may increase tax evasion. The paper also discusses the interaction between voting on taxes and the choice of audit rate by a budget-maximizing bureaucrat.

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1. Introduction

Following Allingham and Sandmo (1972), the literature has analyzed tax evasion as a gamble by taxpayers, where the odds depend on enforcement by the tax authority. From this model, the proposition that stricter enforcement—through increased auditing frequency or larger fines—decreases tax evasion follows straightforwardly. For instance, higher detection probabilities reduce the marginal benefit of evasion and therefore make evasion less attractive.¹ In extensions to this model, stricter enforcement may increase evasion through taxpayers' labor supply responses. For instance, with a backward bending labor supply curve, it may be that with stricter enforcement individuals will evade more (Cowell, 1985).

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¹ The earlier literature assumed that enforcement is exogenous. There are more recent treatments, which assume that enforcement is determined by the tax authority maximizing against taxpayers. See Andreoni et al. (1998) and Slemrod and Yitzhaki (2002) for a survey of this and other issues in tax compliance.

In this paper, I argue that stricter enforcement may increase tax evasion, not through labor supply or other such behavioral effects but rather through a political effect. In particular, it may be that stricter enforcement makes redistributive taxation more attractive for the decisive voter and this may increase tax evasion.

I present a model where voters decide on a linear income tax. Total proceeds are used to finance lump sum grants. Taxpayers may choose to evade taxes and, hence, pay tax on their declared income. When enforcement becomes stricter, voters have two ways to react: by changing evasion and by changing the tax rate. For given tax rate, taxpayers would evade less. However, the equilibrium tax rate will change as well. If richer individuals evade particularly large amounts, stricter enforcement puts a larger burden on them. Hence, lower income voters may prefer higher taxes since the tax system becomes more progressive. In this case, while stricter enforcement in itself reduces evasion, the effects of the increased tax rate (and transfer) may offset this effect, since higher taxes and transfers would make evasion more attractive.

The model combines a standard tax evasion model with a majority voting model of redistributive income taxes. The tax evasion model was pioneered by Allingham and Sandmo (1972) and Yitzhaki (1974). Models where heterogeneous individuals vote on redistributive taxation have been studied by Romer (1975), Roberts (1977) and Meltzer and Richard (1981). A model similar to the present one is presented by Roine (2003), but he looks at (legal) tax avoidance instead of evasion. Hence, enforcement plays no role in his model. His focus is also on the redistributive properties of the voting model.² The interplay between public goods supply and tax evasion is studied by Cowell and Gordon (1988) and Falkinger (1991). Two experimental studies on tax evasion and voting are presented by Alm et al. (1995) and Feld and Tyran (2002). Their focus is on the influence of voting on social norms of tax compliance.³

The paper proceeds as follows. Section 2 presents the model. The voting game is introduced in Section 3. Section 4 contains the comparative statics. Section 5 presents a numerical example. The choice of audit rate is endogenized in Section 6, where bureaucrats are assumed to set audit rates to maximize their budget. Section 7 concludes the paper.

2. The model

Individuals have utility $u(c)$, defined over consumption, c , with $u' > 0$, $u'' \leq 0$. The absolute degree of risk aversion is $\rho'(c) = -u''(c)/u'(c)$. I will assume decreasing absolute risk aversion (DARA) for most of this paper, i.e., $\rho'(c) < 0$. An individual is identified by her gross income level, y , which is assumed to be exogenous. Income is distributed according to a cumulative distribution function $F(y)$ with density $f(y)$. Total population is

² See Borck (2003) for an analysis of the redistributive properties in a variant of the present model.

³ On models with social customs, see, e.g., Myles and Naylor (1996). Orviska and Hudson (2003) empirically test for the significance of deterrence and social norms in attitudes towards evasion and find evidence for both.

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